United States Department of Agriculture
FARM CREDIT ADMINISTRATION
Washington, D. C.

SUMMARY OF CASES

RELATING TO

FARMERS' COOPERATIVE ASSOCIATIONS

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COOPERATIVE RESEARCH AND SERVICE DIVISION

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RESIDUAL EQUITIES IN MEMBERSHIP COOPERATIVES

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Although the dissolution of an agricultural cooperative association like that of any corporation is not often burdened with the problem of distribution of any large surplus, the problem does arise. Recent discussions of the subject have prompted me to review the law and recall the various provisions of articles of incorporation and by-laws examined over a period of years.

When a corporation winds up and dissolves (voluntarily or otherwise) the assets are to be used to liquidate the claims of general creditors. Any excess should serve to retire what are commonly called capital equities (shares of stock, certificates of indebtedness, Revolving Fund certificates, etc.).* After liquidation of such securities there may remain some distributable property which can perhaps best be called residual assets. The primary purpose of this writing is to express a viewpoint with respect to residual assets. Who is entitled to share in the residual assets?

Any discussion of dissolution of the type of corporation we have in mind necessarily involves consideration of property rights and interests of members of the corporation if the corporation is of the nonstock type. In the case of a cooperative organized with shares of stock, ordinarily the problem with respect to rights of the shareholders on dissolution is not difficult of solution. However, in the case of a nonstock association there must be some rule or principle under which the rights of the members are determined when the association winds up and dissolves.

Because of the necessity of establishing a rule or principle for the determination of property rights and interests, the typical statute for the incorporation of a cooperative marketing or purchasing association requires that there be included in the articles of incorporation a statement as to whether property rights and interests are equal or unequal, and the rule or rules applicable when the property rights and interests are unequal. The requirement of the California Act is typical and substantially follows the so-called Standard or Bingham Act. Subdivision (e) of Section 1196 of the California Agricultural Code states that the articles of incorporation of an association organized thereunder shall state "(e) If organized without shares of stock, whether the voting power and the property rights and interests of each member are equal or unequal; and if unequal, the general rule or rules by which the voting power and the property

*Unfortunately in some associations there is a serious doubt as to whether in law the so-called capital equity holders are such. If the legal structure is not clear and complete they may be general creditors.

rights and interests, respectively, of each member may be and are determined and fixed; ....." Section 5 of the Uniform Agricultural Cooperative Association Act contains substantially the same language with respect to property rights and interests of members.

It is significant that in the case of a stock association inclusion of any such rule in the articles of incorporation is neither necessary nor proper. The development of the membership type corporation and the abandonment of the now historical rules of escheat and reverter* made necessary the establishment of a means of determination of property rights and interests in absence of the device which ordinarily makes that determination in the case of the usual commercial corporation, namely, shares of stock.

It is unquestionably true that the draftsmen of the articles of incorporation of many agricultural cooperative associations have not properly understood the requirement of the statutes with respect to the statement of the property rights and interests of members. The articles of incorporation of many associations imply that the member has a present vested interest in the real and personal property of the association. The member of a non-stock corporation, whether it is a profit or non-profit corporation, does not have any more legal title or interest in the assets of the corporation than does a shareholder in any stock corporation. His is the interest or share in the corporation which becomes an interest in property of the corporation in the event of dissolution. If upon termination of membership there is some requirement for the payment of the value of his share or membership interest in the corporation, he might have a claim against the corporation but not a vested interest in its property.

Careful analysis makes it clear that only members can have property rights and interests in a given association in the sense which the expression "property rights and interests" is used in the various cooperative statutes and as a substitution for the interest which a share of stock by its nature carries with it.

The decision of the United States Circuit Court of Appeals in the case of Fertile Cooperative Dairy Association v. Huston (1941, 119 F. (2) 274) has lead some lawyers to the conclusion that all patrons of a cooperative association, whether they are members or not, are entitled to or must have property rights or interests in an association if the association is to maintain its status as exempt from Federal income taxes under Section 101 (12) of the Internal Revenue Code. There is no doubt that the Fertile Dairy case calls for a

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*"At common law, on the death or dissolution of a corporation, its real estate reverted to the grantors and its personal property escheated to the King, but although the common law rule was followed in a few early cases in this country, it has been criticised and almost wholly repudiated, and, generally speaking, it applies now only to rare cases where a defunct private corporation has no members and owes no debts, or, with qualifications, to charitable corporations....." 19 C.J.S. 1488.

recognition of the rights of nonmembers who by their patronage contribute to the building up of corporate assets; however, it is submitted that that case does not require the giving to nonmembers rights which by state law properly exist only in members. In other words, the phrase "property rights and interests" as used in the state statutes governing the incorporation of agricultural cooperative associations is not, by the Fertile Dairy case, made applicable to nonmembers.

A brief review of the facts and decision in the Fertile Dairy case will bear repetition. In the language of the Court "The association paid its patrons, both members and nonmembers, the same amount in cash per pound for the butterfat received from them, such payments being made monthly by a distribution of the net proceeds derived from the butter sold, after deducting all operating expenses and such sums as the board of directors deemed it advisable to withhold for business needs." During the period in question the association built up assets which could not properly be chargeable to operations and had to be treated as capital assets. No provision was made for issuing any form of security such as revolving fund certificates for the amount which was withheld from the nonmembers for the building up of the capital assets. As a consequence, something was taken from the nonmembers for which they were given nothing in return. The members, on the other hand, having property rights and interests in the corporation would, theoretically at least, be entitled to a return for their share of contributions to the capital assets when the corporation is dissolved. The Court stated "Even if it had been incontrovertibly established that the surplus apportionment and equipment expenditures in question were reasonable and necessary they would still have to involve an equality of treatment, as between nonmember and member patrons." In holding the association non-exempt from income tax the Court said "Provision must at least have been made by appropriate enabling action on the part of the association and by adequate, protective entries on its books and records for nonmembers in such a situation as is here involved to share ratably with members, in an ultimate liquidation of the association's assets, on the basis of their comparative contributions thereto."

It is submitted that compliance with the rule in the Fertile Dairy case does not mean that a nonmember must be given property rights and interests within the meaning of the incorporating statutes to permit him to share in residual assets on dissolution. He must have a right to a return of money taken from him which ultimately found its way into capital assets even if he has to wait until dissolution; however, it does not require that the nonmember be given anything over and above that minimum. Let us suppose that the Fertile Cooperative Dairy Association were a stock corporation, the common stock of which constituted membership. In addition, let us suppose that preferred shares were issued to all patrons for deductions over and above operating expenses. If the nonmembers (those not holding common stock) were issued preferred stock for the deductions over and above operating expenses, it could not seriously be con-

tended that they were being subjected to the fatal discrimination which existed in the case as reported, nor could it seriously be contended that as holders of preferred stock, they must be entitled to share in the residual assets on dissolution. If they received preferred stock for the amount invested there would be no discrimination violative of Section 101 (12) of the Internal Revenue Code. If on dissolution, after the preferred stockholders had received the value thereof, and the common stockholders had received the value of their shares, there still remained a residue, the preferred stockholders would not be entitled to share in that residue. Presumably the residue would be in the nature of a "profit" which, under the Internal Revenue Code, the preferred shareholders may not enjoy. Section 101 (12) reads in part as follows: "Exemption shall not be denied any such association because it has capital stock,..... and if substantially all such stock (other than non-voting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise beyond fixed dividends) is owned by producers who market their products or purchase their supplies and equipment through the association; ..."

As stated above, some lawyers in their desire to follow the mandate of the Fertile Dairy case have attempted to give nonmember patrons a right in residual assets, not just merely a certificate or some form of security which would entitle the nonmember patrons to a return of the amount of investment, but a share in residual assets or increment to that investment. This is an attempt to give a nonmember a property right and interest in the corporation which he does not and cannot have if the state incorporating statutes mean what they say, namely, that only a member may have a property right and interest. In one instance, corporate theory was so far departed from in an association's by-laws that they provided that only patrons (both members and nonmembers) of the supply department of a marketing and purchasing association would be entitled to share in inventory of that department in the event of dissolution of the association. Such provisions are an attempt to give nonmembers not only property rights and interests but property rights and interests in specific assets. There can be no legal sanction to such a plan.

Of course, the use of the expression "property right and interest" in the relatively narrow sense of the incorporating statutes must be thoroughly understood. Obviously a bank which lends money to an association has a property right and interest in the broad sense and any nonmember who does business with the association has a property right and interest, but not as an owner or a kind of shareholder in the corporation.

The Uniform Cooperative Agricultural Association Act in its provisions on voluntary dissolution are such as to make clear that right to share in residual assets exists only in members. Subdivision (I) (a) of

Section 20 of the Uniform Act imposes upon the trustees in dissolution the obligation to liquidate the association's assets, "pay its debts and divide any surplus among the members in accordance with their respective rights and interests under their contracts with the association and the articles of incorporation and by-laws." This appears to be no more than a correct statement of general law.

The Florida Supreme Court has contributed two decisions to the subject of dissolution of cooperative associations. These decisions are clear judicial recognition of the viewpoint that property rights and interests belong to members only, as opposed to the contention that former members have such property rights and interests as to justify their sharing in assets on dissolution.

The first decision is in the case of Clearwater Citrus Growers Association v Andrews (1921) 81 Fla. 299, 87 So. 903. In this case, allegedly on the advice of counsel, three-fourths of the members of the defendant cooperative withdrew from the association for the purpose of effecting its dissolution. The statutory procedure for corporate dissolution was not followed. The defendant continued as a going corporation with its diminished membership. The plaintiffs (the former members) sought the appointment of a receiver and dissolution of the cooperative, with the consequent distribution of assets among former and present members. The Supreme Court of Florida states the question as follows: "The situation presented is this: The Clearwater Citrus Growers Association is a going corporation, not for profit, from which some of its members who voluntarily withdrew about seven years ago, are asking that the affairs of the corporation be wound up and its assets divided and that they receive a portion of them. Just where the independent equity exists from this situation we fail to see." The Court states "It has been held that upon the withdrawal of a majority from an organization or corporation, not for profits, those remaining in the corporation constitute the true association and are entitled to the use and enjoyment of the association's property." With respect to the plaintiffs, the Court says "Having withdrawn from the association, they surrendered all right they had as members, including their interest in the property or assets of the association, and this Court is without power to appoint a receiver to wind up the business of the association upon their application, and make equitable division of its assets among the parties entitled thereto. Even if this Court had the power to comply with this part of the prayer of the bill, the assets would have to be divided among present members of the association, as they and they alone have any interest in its property or assets. All of those who have withdrawn, resigned, 'seceded' or otherwise ceased to be members of the association have by their voluntary acts forfeited and surrendered all right to or any interest in the same." In spite of the Court's

language which implies a present interest of members in the property of the association, which is technically not correct, the case clearly affirms the proposition that only members have property rights and interests.

The case of Ozona Citrus Growers v. McClean (1935, 122 Fla. 188, 165 So. 625) makes a distinction between property rights and interests and deductions for the revolving fund or other capital of the association. In this case the defendant association ceased to do business at the end of the 1924 season. Plaintiff's testator had ceased to be a member of defendant on June 2, 1923. Plaintiff asked for appointment of a receiver and dissolution of the association. The lower court held that plaintiff's testator was not a member of the association and, therefore, had no right to the distribution of assets; however, it did hold that the balance of the "retains" should be paid before any distribution of assets was made. The Supreme Court of Florida affirmed the trial court's decision. The association had appealed on the ground that when plaintiff's testator had ceased to be a member he had, within the doctrine of Clearwater Citrus Growers Association v. Andrews (supra), forfeited all rights or interests in the association; however, the Court makes a logical distinction between retains and a right to the distribution of assets on dissolution. The Court said "It is shown that appellant /defendant association/ ceased to function as a going concern soon after appellee /i.e., plaintiff's testator/ retired from it. Whether it was the practice of the association or not to prorate back to its members any 'retains' on hand at the end of the season, in view of its demise, appellee had a right to recover his prorata part of any surplus on hand arising from 'retains' for handling citrus fruit during his membership. Hood River Orchard Co. v. Stone, 97 Or. 158, 191 P. 662. For this purpose and no more, was he entitled to the relief sought."

Undoubtedly Clearwater Citrus Growers Association operated in the familiar manner of retaining for capital a part of the proceeds of sale of members' products and periodically paying back to the members the amounts thus withheld. In other words, the association was undoubtedly operating under the revolving fund plan. The Court properly distinguished revolving fund credits from the property rights and interests of the members. This is a vital distinction that is not always respected by the draftsmen of articles of incorporation and by-laws of agricultural cooperative associations.

In some instances attempts are made to identify property rights and interests with revolving fund credits. The fallacy of such identification is evident when one considers the recognition given to the practice of members' assigning revolving fund credits to non-members even though membership and property rights and interests as such might not in a given association be assignable. Obviously there is no objection to providing that revolving fund credits shall serve as a measurement or yardstick for determining unequal property rights and interests; however, it seems to be incorrect to provide that revolving fund credits as such evidence property rights and interests. If such credits serve as a means of measuring property rights and interests, it is no different from having property rights and interests measured by acreage, tonnage, or other means of relating patronage to property rights and interests.

At times one finds that the articles of incorporation of an association provide for equal property rights and interests and yet in the association's by-laws the provisions respecting dissolution require that after payment of all association debts and retirement of revolving fund credits any residual assets must be distributed to members in accordance with the revolving fund credits which they hold at the time of dissolution. Such provisions are patently in violation of the equal property rights and interests theory set forth in the articles of incorporation. If the property rights and interests are by contract equal, then it is only logical to provide for the distribution of residual assets (after payment of debts, return of membership fee, and liquidation of outstanding revolving fund credits) equally among those who are members at the inception of dissolution proceedings. Another example of the departure from the proper concept of property rights and interests is found in the case of an association with unequal property rights and interests which are measured by (but not evidenced by) revolving fund credits. In a number of such associations it is provided that upon dissolution the assets shall be distributed and applied first in payment of all debts and liabilities other than those represented by revolving fund credits. It is further provided that if any residue remains it shall be used in payment of revolving fund credits. With respect to any excess (residual assets) after payment of revolving fund credits, the by-laws of such associations say that it is to be distributed among all those who ever have been members in accordance with all revolving fund credits ever held by them. This final provision violates the principles enunciated in the above-mentioned cases. It is submitted that the residual assets should be distributed to those who are members at the inception of dissolution proceedings in accordance with their property rights and interests as they are established in the articles of incorporation.

Because of the questions which will inevitably arise in some instances, careful consideration should be given to the meaning of property rights and interests in the membership type of corporation; the nature and characteristics of the association's funds should be well understood and clearly defined in the association's legal structure. It follows that the provisions respecting dissolution will then conform with the requirements of the incorporating statute and the likelihood of litigation will be minimized.

Reserves of Association Held Property of Members

In the Summary of Cases Relating to Farmers' Cooperative Associations No. 15, at page 12, will be found a copy of the unpublished decision of the United States Board of Tax Appeals, now the Tax Court of the United States, in the case of San Joaquin Valley Poultry Producers' Association v. Commissioner of Internal Revenue, holding that this nonexempt association was liable for the payment of income taxes on certain reserves which the Association had accumulated. This case was appealed by the Association to the Circuit Court of Appeals for the Ninth Circuit, and there follows a complete copy of the opinion (136 F. 2d 382) of that court, reversing the Board of Tax Appeals:

IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

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San Joaquin Valley Poultry Producers' Association, Petitioner,	)	
vs	)	No. 10,246
	)	Jun. 5, 1943
Commissioner of Internal Revenue, Respondent.	)	

Petition to Review a Decision of the United States Board of Tax Appeals

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Before MATHEWS, HANEY and HEALY, Circuit Judges.

MATHEWS, Circuit Judge

Here for review is a decision of the Board of Tax Appeals 1/ which sustained a determination by respondent, the Commissioner of Internal Revenue, that there were deficiencies in respect of petitioner's income taxes for 1936 and 1937. The determination resulted from respondent's inclusion of three sums ($1,683.56, $2,215.29, and $5,722.72) in computing petitioner's net income for 1936 and his inclusion of two sums ($2,601.90 and $5,358.46) in computing petitioner's net income for 1937. The question is whether or not these sums -- the $1,683.56, the $2,215.29,

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1/ Now called the Tax Court of the United States.

the $5,722.72, the $2,601.90 and the $5,358.46 -- were income of petitioner.

Petioner is a nonprofit cooperative association. It was organized (incorporated) in 1925 under title 23 (§§ 653aa-653yy) of part 4 of division 1 of the Civil Code of California. Sections 653bb, 653cc and 653ff-653yy of the Civil Code were repealed in 1933 and were superseded by chapter 4 (§§ 1191-1221) of the Agricultural Code of California. 2/ Section 1217 of the Agricultural Code provides: "Any corporation or association organized [as petitioner was] under previously existing statutes for the purpose of cooperatively marketing products as defined in this chapter 3/ shall be deemed organized and existing under and by virtue of the terms of this chapter, and all of the provisions of the terms of this chapter, and any of the restrictions and benefits thereof shall apply in all of their terms to such corporation."

Section 1192 of the Agricultural Code provides: "Associations organized [under chapter 4] shall be deemed 'nonprofit,' inasmuch as they are not organized to make profit for themselves, as such, or for their members, as such, but only for their members as producers."

Section 1194 provides that each association organized under chapter 4 may engage in any activity in connection with the marketing, selling, preserving, harvesting, drying, processing, manufacturing, canning, packing, grading, storing, handling or utilization of any products produced or delivered to it by its members, or any activity in connection with the purchase, hiring or use by its members of supplies, machinery or equipment; act as the agent or representative of any member or members in any of the above mentioned activities; borrow money; establish reserves; levy assessments; and use or employ any of its facilities for any purpose, "provided the proceeds arising from such use and employment shall go to reduce the cost of operation for its members; and provided, further, that the products of nonmembers shall not be dealt in to an amount greater in value than such as are handled by it for its members."

Petitioner's articles of incorporation 4/ state that it is formed to engage in any activity in connection with the marketing, selling, packing, grading, storing, handling or utilization of any poultry, eggs

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2/ Stats. 1933, pp. 60, 255-264, 294-298.

3/ Section 1191 of the Agricultural Code defines "products" as including "horticultural, viticultural, forestry, dairy, live stock, poultry, bee or any farm products."

4/ Section 1196 of the Agricultural Code provides that the articles of incorporation of any association organized under chapter 4 shall state, inter alia, the purposes for which it is formed.

or other agricultural products produced or delivered to it by its members, or any activity in connection with the purchase, hiring or use by its members of supplies, machinery or equipment. The articles provide that petitioner "shall conduct and carry on its business without profit to itself."

Petitioner's by-laws 5/ state that its purpose "is to provide for its members a collective system of marketing poultry, poultry products and other agricultural products, to furnish to them any feed, seed or supplies and, to the end of lessening the cost of such service, to do the same things for those who are not members;" that it "is organized as a nonprofit cooperative organization;" and that "The 'net proceeds' resulting from the operation of the business, if any, shall belong to the members." The by-laws provide: "The Association /petitioner/ does and shall consist of poultrymen and other agricultural producers who shall have been duly elected and shall have paid the membership fee of Ten ($10.00) Dollars. *** The membership fee *** must be paid in cash at the time application for membership is made. *** All moneys received from membership fees shall constitute the membership fund, which fund shall not be reduced except when returned to members upon withdrawal or loss of membership as provided in these by-laws; it may, however, be invested in lands, buildings or equipment necessary for the operation of the business of the Association, or it may be used as working capital of the Association ***."

Petitioner's directors 6/ were authorized to establish reserves 7/ and did establish three -- one called reserve for overpayment, 8/ and one called reserve for security of the membership fund 9/ and one called

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5/ Section 1200 of the Agricultural Code provides that each association shall adopt, for its government and management, a code of by-laws not inconsistent with chapter 4.

6/ Section 1201 of the Agricultural Code provides that the affairs of the association shall be managed by a board of not less than three directors. Petitioner has seven directors.

7/ Agricultural Code, 1194, supra.

8/ To protect petitioner against overpayment of egg sale proceeds to its members. As found by the Board: "The returns from the marketing of eggs was uncertain. When the petitioner paid its members for eggs still unmarketed and at prices then quoted on the market, it ran the risk that it would not realize as much when the eggs were sold by it. Uncertainty in estimating expenses was also involved. This reserve was intended to protect the petitioner against both these risks.

9/ This, the Board found, was to protect petitioner against diminution of its working capital "by a too sudden reduction in membership."

reserve for zoning hazard. 10/ All moneys placed in these reserves were taken from, and constituted part of, the "net proceeds" resulting from the operation of petitioner's business.

Petitioner engaged in the business of marketing eggs for its members and selling supplies to its members and others. It did not pay its members the entire net proceeds of the eggs which it marketed for them in 1936, but retained $1,683.56 thereof -- the $1,683.56 hereinabove mentioned -- and placed this sum in its reserve for overpayments. It did not sell supplies to its members or other customers at cost, but sold them at prices which included cost, plus "overcharges" sufficient to cover expenses and leave a balance which the by-laws speak of as "net proceeds." 11/ It refunded part of the "net proceeds" to its customers (members and nonmembers) and retained the balance. The balance so retained in 1936 included the $2,215.29 and the $5,722.72 hereinabove mentioned. The balance so retained in 1937 included the $2,601.90 and the $5,358.46 hereinabove mentioned. Petitioner placed the $2,215.29 and the $2,601.90 in its reserve for security of the membership fund and placed the $5,722.72 and the $5,358.46 in its reserve for zoning hazard.

The sums so placed in these reserves -- the $1,683.56, the $2,215.29, the $5,722.72, the $2,601.90 and the $5,358.46 -- never became the property of petitioner, but were and are the property of the members. Bogardus v. Santa Ana Walnut Growers' Assn., 41 Cal. App. 2d 939, 946-949, 108 P. 2d 52, 56-58. See, also, Mountain View Walnut Growers' Assn. v. California Walnut Growers' Assn., 19 Cal. App. 2d 227, 65 P. 2d 80; Reinert v. California Almond Growers' Exchange, 9 Cal. 2d 181, 70 P. 2d 190. To hold otherwise would be to hold that petitioner could and did "make a profit for itself, as such," in contravention of its by-laws, its articles of incorporation and the statute to which it owes its existence. Bogardus v. Santa Ana Walnut Growers' Assn., supra.

10/ To protect petitioner against the possibility that the City of Porterville, where petitioner had its office, warehouse and feed mill, might enact a zoning ordinance which would necessitate removal to another part of the city or to a point outside the city.

11/ The by-laws provide: "The 'net proceeds' shall be such funds as are derived from overcharges on sales and as are left after all expenses shall have been paid, or provided for, all at the discretion of the directors. The 'net proceeds' resulting from the operation of the business, if any, shall belong to the members and shall be known as 'members' purchase credits' and shall be prorated to them in proportion to the amount of business each member had transacted with /petitioner/ during the time such 'members' purchase credits' have accumulated."

Petitioner never pretended to be the owner of these sums, but, as required by its by-laws, 12/ "prorated" and credit them to its members. The fact that the sums were not payable to the members on demand, or at any fixed time, does not alter the fact that they were their property and not petitioner's. Petitioner held them, not as owner, but as agent or trustee for the members. Bogardus v. Santa Ana Walnut Growers' Assn., supra. Since none of the sums ever belonged to petitioner, they could not be, and were not, income of petitioner.

In support of his contention that the sums in question were income of petitioner, respondent cites Fruit Growers Supply Co. v. Commissioner, 9 Cir., 56 F. 2d 90; Cooperative Oil Co. v. Commissioner, 9 Cir., 115 F. 2d 666; Farmers Union Cooperative Co. v. Commissioner, 8 Cir., 90 F. 2d 488; Farmers Union Cooperative Supply Co. v. United States, Ct. Cl., 25 F. Supp. 93; Callaway v. Farmers Union Cooperative Association, 119 Neb. 1, 226 N.W. 802. None of these cases involved a nonprofit cooperative association organized under chapter 4 of the Agricultural Code of California. Fruit Growers' Supply Company was not a nonprofit cooperative association, but was an ordinary California corporation. Cooperative Oil Company was an Idaho corporation. Farmers Union Cooperative Company, Farmers Union Cooperative Supply Company and Farmers Union Cooperative Association were Nebraska corporations. These cases are not in point. Petitioner is a California corporation and transacted all its business in California. Hence, in determining whether moneys it received were its property or the property of its members, the applicable law is that of California. Poe v. Seaborn, 282 U.S.101, 110-113; Blair v. Commissioner, 300 U.S. 5, 9-10; Lang v. Commissioner, 304 U.S. 264, 267; Helvering v. Fuller, 310 U.S. 69, 74-75.

Decision reversed.

(Endorsed:) Opinion. Filed Jun. 5, 1943. Paul P. O'Brien, Clerk.

12/ See footnote 11.

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This opinion, if it is followed so that it becomes the settled law applicable to like situations, may have quite a revolutionary effect. It should be kept in mind that the question of whether the Association was exempt from the payment of Federal income taxes was not before the court; nor was the character of the reserves in any way involved.

The opinion in this case looks toward the position that any cooperative association which is incorporated under a statute which provides

for the formation of nonprofit associations and which has provisions in its organization papers providing in effect that any "underpayments" or "overcharges" which an association makes which result in an association having money in its treasury over and above its operating costs and expenses, which money is declared by the association's organization papers to be property of its members, and which is allocated on its books to the members who furnished the same, and which at the option of the association may be paid to them, has no income and hence has nothing on which to pay income taxes.

The court, in reading its conclusion, among other things said:

> Section 1192 of the Agricultural Code provides: "Associations organized /under chapter 4/ shall be deemed 'nonprofit,' inasmuch as they are not organized to make profit for themselves, as such, or for their members, as such, but only for their members as producers."

It stated that -

> Petitioner's articles of incorporation * * * provide that petitioner "shall conduct and carry on its business without profit to itself."

The court further pointed out that the bylaws of the Association stated that the Association "is organized as a nonprofit cooperative organization" and that "The 'net proceeds' resulting from the operation of the business, if any, shall belong to the members" and that as required by its bylaws, the sums in question were "prorated and credited to its members."

The principle announced by the court would be applicable to any type of cooperative association, agricultural or otherwise, if it were formed under a statute comparable to the California statute, and if it had provisions in its organization papers comparable to those contained in the organization papers of the San Joaquin Valley Poultry Producers' Association. It would mean, if it becomes the established law, that any type of cooperative organization formed under a statute like the California statute, and having provisions in its organization papers regarding its cooperative status like those contained in the organization papers of the San Joaquin Valley Poultry Producers' Association, would not be required to pay Federal income taxes on any reserves which it accumulated. This would mean that all such cooperative organizations would be virtually "exempt" from the payment of such taxes, although the Federal income tax statutes did not provide for their exemption. This result would follow because the costs and expenses of operating any organization are deductible in computing

income taxes, and if all amounts received by an association in excess of its costs and expenses were carried to reserves, it would have no taxable income under the opinion under discussion.

As indicated, the opinion in this case presents a point of view that is quite different from that reflected in the holdings in other cases. Indeed, it is difficult to reconcile the opinion in the case under discussion with the holding of the same court in Co-operative Oil Association v. Commissioner of Internal Revenue, 115 F. 2d 666, discussed in Summary No. 9, page 5, in which a contrary conclusion was reached, although the association was incorporated under a statute quite similar to the California statute.

The court regarded the reserves as the "reserves of the association", although the sums in the reserves "never became the property of petitioner, but were and are the property of the members." It strikes one as anomalous that any corporation could have reserves consisting of property belonging to others. If the reserves were the reserves of the Association, one might ask why the sums composing the reserves were not the property of the Association, but of course, the owner of property may give another such jurisdiction over such property as may be deemed advisable.

In support of its conclusion that the sums so placed in these reserves never became the property of the Association, the court cites the case of Bogardus v. Santa Ana Walnut Growers' Assn., 41 Cal. App. 2d 939, 108 F. 2d 52 (see Summary No. 11, page 5). That case, however, differed from the case under discussion in that the amounts there in question were amounts which were due and owing to the members of the association under its marketing contracts and bylaws. The members were simply creditors of the association for unpaid balances which the association was obligated to pay to them.

This situation, it is submitted, is quite unlike the situation involving the reserves of the San Joaquin Valley Poultry Producers' Association. In the Bogardus case the association was not entitled to hold the money involved, but in the instant case the amounts in question were in reserves over which the Association had "unfettered command" without any liability to its members therefor.

The court ruled that the Association held the reserves "not as owner, but as agent or trustee for the members." The court further said, "Since none of the sums ever belonged to petitioner, they could not be, and were not, income of petitioner." Accepting the statement that the amounts in question were held by the Association as trustee, the question naturally arises as to the purposes for which the Association was entitled to use the funds. Trust funds may be used by

the trustee for only the purposes specified by the person or persons furnishing the trust money. The opinion does not attempt to itemize the purposes for which the money could be employed by the Association.

By reference to the opinion of the Board of Tax Appeals, it will be observed, however, that the Association could use the funds in question as a part of its working capital in the general operations of the Association. If under circumstances like those in question reserves may be used only for the purposes for which such reserves have been created, then those loaning money to such an association should proceed with this fact in mind.

The Supreme Court of the United States has held in numerous cases (see Corliss v. Bowers, 281 U.S. 376 and cases cited therein) that where a taxpayer has unfettered command over "income", as the Association appears to have had in this case, that the "income" constitutes income from the standpoint of income taxes.

It is submitted that if the court could have found from the facts at hand that the funds in question had been furnished by the members as capital for the Association, it would have been clear that such amounts were not taxable, as contributions to capital made by members of an association do not constitute income and hence are not taxable under the 16th amendment to the Federal Constitution.

As the court held that the money constituting the reserves was the property of the members, it appears in order to inquire if this money should have been reported by the members in their income tax returns. As income, it obviously was taxable income either to the association or to its members.

Reserves May Be Invested In Government Bonds

The question has arisen of whether an agricultural cooperative association which is exempt from the payment of Federal income taxes may invest money in its reserves in Government bonds, the income from which is not exempt, without adversely affecting its exemption from the payment of Federal income taxes. The answer to this question is given in the following ruling of the Bureau of Internal Revenue found in C. B. 1941-2, page 78:

SECTION 19.22(b) (4)-4: Interest upon United States obligations. 1941-34-10810 I. T. 3499

INTERNAL REVENUE CODE.

> The M Lodge, which has been held to be exempt from Federal income tax under section 101(3) of the Internal Revenue Code, is not subject to Federal income tax on interest received by it on United States savings bonds.

The M Lodge, which has been held to be exempt from Federal income tax under section 101(3) of the Internal Revenue Code, desires to invest its surplus funds in United States savings bonds, and has inquired whether the lodge will be required to pay Federal income tax on the interest received by it on such bonds. Similar inquiries have been received from other exempt organizations.

The Public Debt Act of 1941, approved February 19, 1941, provides that the interest upon, and the gain from the sale or other disposition of, obligations issued on or after March 1, 1941, by the United States or any agency or instrumentality thereof shall not have any exemption, as such, and loss from the sale or other disposition of such obligations shall not have any special treatment, as such, under Federal tax Acts now or hereafter enacted, with certain exceptions not here pertinent. The effect of the provisions of the Public Debt Act of 1941 is to subject all interest upon, and gains from the sale or other disposition of, obligations of the United States or any agency or instrumentality thereof to the same Federal taxes as like income derived from obligations of private corporations is subjected. The Act does not affect the exemption with respect to savings bonds issued prior to March 1, 1941.

Section 101 of the Internal Revenue Code provides for the exemption from income taxation of certain organizations, including fraternal organizations specified therein. Section 1.101-1 of Regulations 103, which relates to the income tax under the Internal Revenue Code, provides that when an organization has established its right to exemption it need not thereafter make a return of income or any further showing with respect to its status under the law, unless it changes the character of its organization or operations or the purpose for which it was originally created. Therefore, any organization which has established its exemption from Federal income taxation under the provisions of section 101 of the Internal Revenue Code or corresponding provisions of prior Revenue Acts is not liable to Federal income tax on any of its income, including interest on, and the gain from the sale of, United States bonds issued before, or on or after March 1, 1941. (Underscoring supplied)

The M Lodge, having been held by the Bureau to be exempt from Federal income taxation under the provisions of section 101(3) of the Internal Revenue Code, will not be required to file returns of income so long as the purposes for which it was organized and its method of operation remain unchanged. Accordingly, such organization is not subject to Federal income taxation on any of its income including interest on United States savings bonds. (See also C. B. 1942-1, page 105.)

It will be remembered that a cooperative association may accumulate and maintain "a reserve required by state law or a reasonable reserve for any necessary purpose" without having any such reserve adversely affect its right to exemption.

Of course, the reserves that may be so accumulated must be for a purpose that is directly identified with furthering the marketing of the products of its members or the purchasing of supplies for them, and must not be for an activity which an association may not directly or indirectly engage in and be eligible for exemption. Assuming that the reserves of an association are being accumulated for a necessary purpose or are reserves required by state law, pending their use for the purpose for which they are being accumulated, the foregoing ruling makes it clear that they may be invested in Government bonds, the income and gain from which is taxable without adversely affecting their right to exemption.

Status of Nonexempt Cooperative Same as Other Business Organizations

In the consolidated cases of McLean County Service Company v. Commissioner of Internal Revenue, and Champaign County Service Company v. Commissioner of Internal Revenue, 45 B.T.A. 1004, the Board of Tax Appeals said: "We can see no injustice or unfairness in treating a cooperative not exempt from tax the same as other business organizations."

In these cases the cooperatives attempted to make certain deductions in computing their income taxes which were held to be out of order. Section 26(c) of the Revenue Act of 1936, 49 Stat. 1664, provides for a credit in computing income taxes "equal to that portion of the adjusted net income which the corporation is prohibited from distributing as a dividend by virtue of the express terms of a written contract executed by the corporation prior to May 1, 1936" (see Oviatt's v. Commissioner of Internal Revenue, 128 F. 2d 352).

The cooperatives contended that they were prohibited by their charters, bylaws, and class A preferred stock and common stock certificates, from paying dividends except dividends not in excess of 7 percent on class A preferred stock, and therefore they urged that they were entitled to a credit based on Section 26(c) in computing their surtaxes on undistributed profits, but the Board of Tax Appeals held that "corporate charters and bylaws are not 'written contracts executed by the corporation' within the meaning of the statute."

Section 27(g) of the Revenue Act of 1936 provides that "No dividends paid credit shall be allowed with respect to any distribution unless the distribution is pro rata, equal in amount, and with no preference to any share of stock as compared with other shares of the same class." Each of the cooperatives urged that it was entitled to certain credits by reason of the statutory provision just quoted, but the Board held that the distributions of patronage dividends to members only, but which included the profits on nonmember business on which the claims for credits were based, were not "pro rata equal in amount and with no preference to any share of stock as compared with other shares of the same class", and hence held that the cooperatives were not entitled to the claimed credits.

The Board further said: "To allow a dividends paid credit to cooperatives which are not exempt from tax under section 101 and which distribute taxable income on a patronage basis would in effect grant them exemption from taxation and violate the clear provisions of section 27(g)."

Unfair Discrimination in Purchasing or Selling

Farmers Co-operative Association filed a suit against Quaker Oats Company alleging that that company, with intent to injure the cooperative association and destroy competition, has paid and was paying higher prices for grain, particularly corn, at Sheldon, Iowa, than the company paid at certain other stations operated by it in Iowa, and that the company has been and was selling feed at Sheldon for less than the price at which it sold the same feed at certain other stations in Iowa.

It appeared that the acts complained of were, if true, violations of the Code of Iowa (1939) which made acts like those in question criminal, and declared void contracts in violation of them. It was made the duty of the county attorneys in their counties and the Attorney General to enforce by appropriate action the provisions of the Iowa Code forbidding acts like those that the Quaker Oats Company was alleged to have committed.

Farmers Co-operative Association sought an injunction against the Quaker Oats Company to prohibit it from engaging in activities like those outlined. In the trial court the petition of the cooperative association was dismissed on the ground, apparently, that the cooperative association was not entitled to an injunction because the acts complained of constituted criminal offenses. On appeal, the Supreme Court of Iowa said (7 N.W. 2d 906) that "As a general rule injunction will not lie to restrain a merely criminal act." In this connection the court cited 28 Am. Jr. p. 336, 1 C.J.S., Actions, p. 996, and 52 A.L.R. 79, annotation. In holding that it was error to dismiss the petition of the cooperative association for an injunction, the court cited a number of cases upholding the right of a plaintiff under conditions similar to those in question to an injunction, and, among other things, said:

> * * * But as stated in 32 C.J. p. 277, Sec. 440: "Notwithstanding the general rule stated above, it is well settled that where the intervention of equity by injunction is warranted by the necessity of protection to civil rights or property interests, and the inadequacy of a criminal prosecution to effect this purpose, the mere fact that a crime or statutory offense must be enjoined as incidental thereto will not operate to deprive the court of its jurisdiction." This, however, is a motion to dismiss and for the purposes of the

motion the facts properly pleaded in the petition will be taken as true. Plaintiff's petition not only alleges that the acts complained of were with the intention of injuring the business of the plaintiff, destroying competition and preventing plaintiff from purchasing grain and selling merchandise, but also alleges in general, malice, irreparable injury and special injury to plaintiff different from any injury that might be sustained by the general public as the result of such acts. These are equitable grounds which may be recognized as a basis for a claim for injunction independent of the statute.

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It seems to us apparent from the rule laid down by the foregoing authorities that this court has sustained the right to a recovery or to equitable relief even where a statute such as the statute here referred to makes the acts complained of a crime, where there is pleaded and established injury to the plaintiff different from that sustained by the general public. In the present case the facts entitling the plaintiff to equitable relief are fully pleaded, and as such, for the purpose of a motion, may be taken as true. We think that plaintiff has set out a cause of action such as entitles him to a hearing thereon in court. We find our answer to the first question in issue must be that if the facts sustain the allegations of the petition such injunction can be granted.

Federal Order Defining Oleomargine Upheld

In Land O'Lakes Creameries, Inc. v. McNutt, Federal Security Administrator (National Co-operative Milk Producers' Federation, et al., Interveners), 132 F. 2d 653, the plaintiffs unsuccessfully challenged on various grounds an order issued by the Federal Security Administrator under the Federal Food, Drug and Cosmetic Act of 1938, 21 U.S.C.A. Sec. 341, establishing a definition and standard of identity for oleomargarine. Among other things, the order of the Administrator prescribed certain optional ingredients which might be used in the manufacture of oleomargarine, among them sodium benzoate, Vitamin A, and diacetyl, and it was claimed that these ingredients were included in the manufacture of oleomargarine in order to produce a product which simulated butter. On account of this fact it was alleged that because the manufacturers of oleomargarine were not required to label their product "imitation butter", the order of the Federal Security Administrator was contrary to section 403(c) of the Federal Food, Drug and Cosmetic Act, 21 U.S.C.A. 343(c), which

> provides that a food shall be deemed misbranded "if it is an imitation of another food, unless its label bears, in type of uniform size and prominence, the word 'imitation' and, immediately thereafter, the name of the food imitated."

In this connection the following quotations are taken from the opinion:

> The petitioners, in their brief assert as follows: "It is quite obvious that the testimony upon which the respondent's order is supposedly based discloses that these various permitted optional ingredients are used for the sole purpose of simulating the genuine product butter. It is the duty under the law of respondent to require manufacturers of oleomargarine if they are to use these ingredients in their product to label their product in accordance with the plain mandate of Congress, namely, with the word 'imitation' together with the name of the product (butter) imitated. This the respondent did not do. His order is repugnant to the provisions of Sec. 403(c) of the Act and consequently void."
>
> The answer of the respondent is that oleomargarine containing the optional ingredients referred to in the

order, is not "an imitation" of butter within the meaning of § 403(c); that the mere resemblance or similarity of one food to another is insufficient to make one an "imitation" of the other; and that what § 403(c) is directed at is preventing a spurious food being passed off as genuine. The respondent also contends that, even if some oleomargarine conforming to the standard of identity might be sold under circumstances which might possibly make it an "imitation" of butter under § 403(c), that fact would not vitiate the standard, since the provisions of § 401, relating to the establishment of standards of identity, and the provisions of § 403(c) requiring that imitations of foods be labelled as such, are not conflicting and are independent of each other.

Oleomargarine is a well known food product with an identity of its own, and there is nothing in the record before us, with the possible exception of the expert opinion expressed by Mr. Lepper (with which the respondent did not agree) to indicate that oleomargarine has been, or is likely to be, passed off as butter; that it is, or is likely to be, used as a deceptive imitation of butter; or that labelling requirements will not effectually protect consumers against fraud. The respondent, we think, has convincingly demonstrated in his brief that, in view of federal and state restriction imposed upon the sale of oleomargarine, it is improbable that it could, as a practical matter, be successfully passed off as butter. But if § 403(c) requires that oleomargarine containing the optional ingredients specified in the standard be labelled "imitation butter," it is our opinion that the respondent's order cannot be invalidated for that reason, because we regard § 403(c) as independent of § 401. If § 403(c) imposed the duty upon the respondent to require all oleomargarine containing the ingredients designated in the standard as optional, to be labelled "imitation butter," that duty existed both before and after the order was made, since the order does not impair, or purport to impair, the effectiveness of § 403(c). The order establishes a definition of a food product, and is not a license, to those who produce it, to violate any state or federal labelling requirements.

Sec. 402(b) (4) of the Act, 21 U.S.C.A. § 342(b) (4), provides that a food shall be deemed to be adulterated "if any substance has been added thereto or mixed or packed

therewith so as to increase its bulk or weight, or reduce its quality or strength, or make it appear better or of greater value than it is." In order to determine whether anything has been added to a food which makes it appear "better or of greater value than it is," it is necessary to know first of all what the food is. The purpose of the respondent's order was to ascertain the ingredients of oleomargarine and to define and identify it. Under the definition which he adopted, oleomargarine is a food which contains the ingredients and optional ingredients specified in the definition and standard of identity. It is not conceivable to us that we could rule that the use of one or more of the optional ingredients would make oleomargarine an adulterated food, and at the same time be of the opinion that the standard of identity established by the order was supported by valid findings of fact and sustained by substantial evidence. We think there is no conflict between the order of the respondent and § 402(b) (4) of the Act.

The opinion, in the case of UNITED STATES v. DAIRY COOPERATIVE ASSOCIATION, believed to be the only Federal anti-trust case to date solely involving a cooperative association, and which opinion was given in full in Summary No. 18, page 6, is reported in 49 F. Supp. 475.

Liability for Failure to Cancel Negotiable Warehouse Receipts

The American Cotton Cooperative Association brought suit against the Union Compress and Warehouse Company for damages sustained by the cooperative association because of the failure of the warehouse company to cancel and take up negotiable warehouse receipts when the cotton for which such receipts were issued was delivered to the holder of the receipts. The warehouse company prevailed in the trial court, but on appeal to the Supreme Court of Mississippi the judgment of the trial court was reversed (7 So. 537).

The warehouse company engaged in storing cotton in bales and issuing negotiable warehouse receipts therefor. It was the duty of its chief clerk, H. E. Avery, to cancel these negotiable receipts when they were surrendered and the cotton represented thereby delivered to the holders of the receipts.

The American Cotton Cooperative Association is an organization composed of State or regional cotton cooperative associations. All of the business of the American Cotton Cooperative in the State of Mississippi was transacted through its only Mississippi stockholder, the Mississippi Cooperative Cotton Association and its agents. One J. R. Haley, an agent of the Mississippi Cotton Cooperative Association, attended to the business of the American Cotton Cooperative Association of making advances of money to the producer members of the Mississippi cooperative on negotiable warehouse receipts for cotton delivered by them to him, or in some cases these receipts were purchased outright. "Avery and Haley agreed with each other, and without the knowledge of their principals, that Avery would not cancel all of the negotiable receipts for cotton issued by the appellee when the cotton represented thereby was delivered to the holder of the receipts, but that he would deliver some of these receipts to Haley, who would use them in obtaining an advancement of money thereon from the appellant by means of forged marketing agreements. Negotiable receipts issued by the appellee for about 164 bales of cotton were thus dealt with and a sum of money aggregating something over $5,000 was obtained by Haley from the appellant thereon in the usual manner in which he conducted the appellant's regular business."

In holding that the warehouse company was liable because of its failure to take up and cancel the negotiable warehouse receipts in question, the Supreme Court of the State said:

> Section 3491 of the Code imposes an absolute duty on a warehouseman who has delivered goods for which he has issued a negotiable receipt to "take up and cancel the receipt." He must do both and in default of either the section imposes absolute liability on him "to any one who purchases for value in good faith such receipt, for failure to deliver the goods to him". This duty is non-delegable and a warehouseman can not escape its obligation by delegating its performance to another. His liability arises when his agent whom he has charged with the performance of the duty fails to do so, to the damage of an innocent purchaser of the receipts, although the agent's omission to discharge the duty was negligent, wilful or criminal. 4 Rest. Torts, Sec. 877 clause (d) and comment (e) thereon; 1 Rest. Agency, Sec. 214. This rule is illustrated by the many cases in this court dealing with the master's duty to provide his servant with a safe place to work, and by Joy v. Farmers' National Bank, 158 Okl. 1, 11 P.2d 1074, wherein a statute similar to Section 3491, Code of 1930, was under consideration.

It was urged by the warehouse company that Avery, its chief clerk, was acting for himself in failing to take up and cancel the negotiable warehouse receipts and that it was not liable for his failure so to do, but the court said:

> It is true that Avery violated his duty to the appellee when he delivered these receipts to Haley for purposes of his own, but that fact can not relieve the appellee from liability for the nonperformance of its non-delegable duty to cancel the receipts when the cotton represented by them was delivered to the holders thereof.

In other words, the court proceeded on the theory that the law of Mississippi made it the positive and non-delegable duty of warehousemen to take up and cancel the warehouse receipts and that a warehouseman could not defend by showing that an agent had violated instructions. On the other hand, the court held that the dishonesty of Haley, the employee of the Mississippi Cooperative Cotton Association, and through it, of the American Cotton Cooperative Association, was in no way attributable to the American Cotton Cooperative Association because Haley -

> was acting adversely to it and entirely for his own and Avery's purposes, pursuant to a scheme entered into by them to defraud the appellant, it is not chargeable with Haley's knowledge of the fact that the cotton represented

by these receipts had been delivered by the appellee to the holder thereof. 1 Rest. Agency, Sec. 282. One of the numerous cases in this state so holding is Scott County Milling Co. v. Powers, 112 Miss. 798, 73 So. 792.

The warehouse company contended that the cotton cooperative association was not entitled to recover because it was a Delaware corporation which had failed to qualify in Mississippi under the foreign corporation statutes of that State. Section 4164 of the Mississippi Code of 1930 provided that "every company or corporation for profit incorporated under or by virtue of the laws of any government, or of any other state or territory, now or hereafter doing business in this state" should file a copy of its charter with the Secretary of State, and in default thereof "shall be liable to a fine of not less than $100.00". The court, however, pointed out that the statutory provision in question was applicable only to corporations "for profit" and that due to the manner in which the American Cotton Cooperative Association was organized and operated, it was not a corporation for profit and therefore the statutory provision had no application thereto. A similar conclusion was reached in a Missouri case, Mutual Orange Distributors v. Black, 221 Mo. App. 493, 287 S.W. 846.

If a cooperative association is required to comply with the foreign corporation laws of a State in which it is doing business, serious results may follow from its failure to comply with such statutes. In many States, an association which fails to comply with the foreign corporation laws of a State, can not sue in the courts of the State, nor can it enforce its obligations in the Federal courts. In Tennessee, the shareholders of a foreign corporation under the circumstances in question were held liable as partners. Cunnyngham v. Shelby, 136 Tenn. 176, 188 S.W. 1147, L. R. A. 1917B 572.